

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re
RONALD BERNARD REECE,
Debtor.

Case No. 96-59712-JRG
Chapter 7

ANTHONY LARA and FRANCES
LARA,
Plaintiffs,
vs.

Adversary No. 97-5141

RONALD BERNARD REECE,
Defendant.

**ORDER GRANTING PARTIAL
SUMMARY JUDGMENT**

I. INTRODUCTION

The issue before the court is whether it is proper to grant summary judgment in this adversary proceeding on the basis of a prior state court's default judgment. For the state court's default judgment to have collateral estoppel effect, it must first satisfy the relevant legal standard for issue preclusion before its findings can be applied to a bankruptcy proceeding, and then a determination must be made with respect to whether the preclusive

1 effect of its findings entitles the creditor to a judgment as a
2 matter of law. A grant of summary judgment will except from
3 discharge the debt incurred as a result of the state court
4 judgment. For the reasons hereafter stated, the motion for summary
5 judgment is granted in part.

6 **II. STATEMENT OF FACTS**

7 On July 16, 1992, Anthony and Frances Lara brought an action
8 for fraud and negligence in the California Superior Court of Santa
9 Clara County, against Ronald Bernard Reece. Reece filed an answer
10 to the Laras' complaint on September 15, 1992. The Laras filed
11 their first amended complaint in the Superior Court on March 18,
12 1993, alleging eleven causes of action, including fraud, deceit,
13 negligent misrepresentation and constructive fraud. The first
14 amended complaint asserted that Reece made false representations
15 with knowledge that they were false. Reece failed to answer the
16 amended complaint. Consequently, the Laras requested that the
17 Superior Court enter a default judgment against Reece. The state
18 court entered a default judgment on May 14, 1993. Reece then moved
19 unsuccessfully to set aside the default judgment.

20 On April 15, 1994, the Superior Court held a "prove-up"
21 evidentiary hearing in which the Laras presented oral testimony and
22 documentary evidence in order to establish damages. Reece did not
23 attend this hearing. The Superior Court subsequently issued an
24 amended default judgment on the same day. In a brief order, the
25 state court made two findings of fraud. First, the court found
26 Reece to be "liable to plaintiffs (Laras) based on fraud,
27 misrepresentation, and deceit in his representation of [them] as
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1 their real estate agent in the purchase and leasing of real
2 property, and further based on negligence." Second, the court
3 ruled that Reece "carried out the acts alleged in the plaintiffs'
4 (Laras') first amended complaint with oppression, fraud, and
5 malice." The state court then awarded \$701,367.69 in general and
6 special compensatory damages, \$15,227.21 in interest, \$250,000 in
7 punitive damages, \$853.94 in costs of suit, and \$240,038 in
8 attorney fees. All told, the entire judgment amounted to a total
9 of more than \$1.2 million.

10 Reece filed a chapter 7 bankruptcy on December 17, 1996. The
11 Laras timely filed a complaint in the bankruptcy court to except
12 from discharge their state court judgment. In an amended
13 complaint, the Laras alleged that the debt is not subject to
14 discharge pursuant to 11 U.S.C. §§ 523(a)(2)(A), (a)(4), and
15 (a)(6). In the answer to the amended complaint, Reece cited a
16 number of affirmative defenses. The Laras filed this motion for
17 summary judgment, arguing that the issues to be determined in the
18 adversary proceeding are the same ones determined by the Superior
19 Court, and, therefore, the doctrine of collateral estoppel should
20 apply to grant them a judgment as a matter of law.

21 **III. LEGAL STANDARD**

22 Summary judgment is granted when no genuine issue exists as
23 to any material fact and the moving party is entitled to judgment
24 as a matter of law. Fed. R. Civ. P. 56; see also Anderson v.
25 Liberty Lobby, Inc., 477 U.S. 242, 250 (1986). Summary judgment
26 has been made applicable to adversary proceedings in bankruptcy
27 courts. Fed. R. Bankr. P. 7056.

1 The moving party for summary judgment has the initial burden
2 to show that no genuine issue of material fact exists. See Bhan
3 v. Nme Hospitals, Inc., 929 F.2d 1404, 1409 (9th Cir. 1991) (citing
4 T.W. Elec. Serv. v. Pacific Elec. Contractors Assoc., 809 F.2d
5 626, 632 (9th Cir. 1987)). The nonmovant's version of the facts
6 must be accepted and all inferences from the underlying and
7 undisputed facts are to be drawn in favor of the nonmovant. See,
8 e.g., Bishop v. Wood, 426 U.S. 341, 348 n.11 (1976); Arnett v.
9 Kennedy, 416 U.S. 134, 139-40 (1974); United States v. Diebold,
10 Inc., 369 U.S. 654, 655 (1962).

11 The party seeking summary judgment always bears the initial
12 responsibility of informing the court of the basis for its motion,
13 and of identifying those portions of the pleadings, depositions,
14 answers to interrogatories, and admissions on file, together with
15 the affidavits, if any, which it believes will demonstrate the
16 absence of a genuine issue of material fact. See Celotex Corp. v.
17 Catrett, 477 U.S. 317, 323 (1986). If the moving party satisfies
18 this burden, the opposing party must go beyond the pleadings and
19 by its own affidavits, depositions, answers to interrogatories, and
20 admissions on file, designate specific facts showing that there is
21 a genuine issue of material fact for trial. Id. at 324.

22 The summary judgment motion in this adversary proceeding is
23 based primarily on the potential collateral estoppel effect of the
24 previous Superior Court default judgment. Federal courts must
25 give state judicial proceedings "the same full faith and credit .
26 . . as they have by law or usage in the courts of [the] State . .
27 . from which they are taken." 28 U.S.C. § 1738. The Full Faith
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1 and Credit Act also requires federal courts to consult state law
2 requirements for collateral estoppel to determine whether the prior
3 court judgments of that state will have preclusive effect. See
4 Marrese v. Am. Academy of Orthopaedic Surgeons, 470 U.S. 373, 380
5 (1985). Collateral estoppel, or issue preclusion, prevents parties
6 from relitigating issues previously argued and decided in another
7 cause of action between them. See Montana v. United States, 440
8 U.S. 147, 153 (1979); see also Teitelbaum Furs, Inc. v. Dominion
9 Ins. Co. Ltd., 58 Cal. 2d 601, 604 (1962). This principle has been
10 held to apply to nondischargeability proceedings in bankruptcy
11 courts. See Grogan v. Garner, 498 U.S. 279, 284-85 (1991). In
12 addition, the Marrese requirement that federal courts refer to
13 state preclusion law to determine the preclusive effect of a state
14 court judgment has been extended to bankruptcy courts. See Gayden
15 v. Nourbakhsh (In re Nourbakhsh), 67 F.3d 798, 800 (9th Cir. 1995).
16 In short, whether a California court judgment will preclude issues
17 in bankruptcy proceedings is a question that will be answered by
18 examining California law on collateral estoppel.

19 **IV. DISCUSSION**

20 **A. The Satisfaction of the Elements for Collateral Estoppel.**

21 Under California law, collateral estoppel has five elements
22 that must be satisfied before it can be invoked: (1) the issue
23 sought to be precluded from litigation must be identical to that
24 litigated in the former proceeding, (2) the issue must have been
25 actually litigated in the former proceeding, (3) the issue must
26 have been necessarily decided in the former proceeding, (4) the
27 decision in the former proceeding must have been final and on the
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1 merits, and (5) the party against whom preclusion is sought must
2 be the same as, or in privity with, the party to the former
3 proceeding. See Lucido v. Superior Court, 51 Cal. 3d 335, 341,
4 cert. denied, 500 U.S. 920 (1991). If the Superior Court's default
5 judgment meets all of these requirements, it will be eligible for
6 collateral estoppel.

7 The second, third, fourth, and fifth elements for collateral
8 estoppel are easily satisfied. The state court decision was final
9 and on the merits. The issues of fraud, malice, and the
10 relationship between the Laras and Reece were necessarily
11 determined in the former action. The Laras and Reece are the same
12 parties as in the previous law suit.

13 Despite Reece's contention, a default judgment also meets the
14 "actually litigated" requirement. California law treats default
15 judgments as "actually litigated," entitling them to collateral
16 estoppel effect. See, e.g., English v. English, 9 Cal. 2d 358, 363-
17 64 (1937); Four Star Elec., Inc. v. F & H Constr., 7 Cal. App. 4th
18 1375, 1380 (1992); Mitchell v. Jones, 172 Cal. App. 2d 580, 586-87
19 (1959); Lake v. Capps (In re Lake), 202 B.R. 751, 757 n.6 (B.A.P.
20 9th Cir. 1996). Since bankruptcy courts must look to state law to
21 determine the preclusive effect of the prior state court judgment,
22 In re Nourbakhsh, 67 F.3d at 801, and since under California law,
23 the doctrine of collateral estoppel may be applied based on a
24 default judgment, Four Star Elec., Inc., 7 Cal. App. 4th at 1380,
25 the default judgments of California state courts possess issue
26 preclusion potential in bankruptcy adversary proceedings. See,
27 e.g., Bay Area Factors v. Calvert (In re Calvert), 105 F.3d 315,

1 316 (6th Cir. 1997); Green v. Kennedy (In re Green), 198 B.R. 564,
2 566 (B.A.P. 9th Cir. 1996); Newsom v. Moore (In re Moore), 186
3 B.R. 962, 971 (Bankr. N.D. Cal. 1995).

4 The question of whether the first requirement for collateral
5 estoppel is satisfied demands a more careful analysis. The issues
6 sought to be precluded must be identical to the issues already
7 litigated. Lucido, 51 Cal. 3d at 341. For the purposes of this
8 adversary proceeding, this requirement means that the elements of
9 fraud and malice proven by the Laras in state court must correspond
10 exactly to the elements of fraud and malice that the Laras would
11 have to prove to except their debt from discharge. A debt is
12 nondischargeable in bankruptcy when the debt results from (1) false
13 pretenses, a false representation, or actual fraud, (2) fraud or
14 defalcation while acting in a fiduciary capacity, or (3) willful
15 and malicious injury committed by the debtor. 11 U.S.C. §§
16 523(a)(2)(A), (a)(4), and (a)(6).

17 **1. The Default Judgment's Collateral Estoppel**
18 **Effect for §§ 523(a)(2)(A) and 523(a)(4).**

19 The state court made two separate findings of fraud in its
20 default judgment. Reece was found to have been "liable to
21 plaintiffs (Laras) based on *fraud*, misrepresentation, and deceit
22 in his representations of [them] as their *real estate agent in the*
23 *purchase and leasing of real property* [emphases added]." In
24 issuing this promulgation, the Superior Court has in effect also
25 ruled that Reece acted in a fiduciary capacity for the Laras, since
26 under California law, a real estate agent owes a fiduciary duty to
27 his principal. See Batson v. Strehlow, 68 Cal. 2d 662, 674-75
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(1968). The state court, moreover, found that Reece "carried out the acts alleged in the plaintiffs' (Laras') first amended complaint with oppression, *fraud*, and malice [emphasis added]." The second finding allowed the state court to award punitive damages pursuant to California Civil Code Section 3294, which provides in relevant part that "where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice, the plaintiff, in addition to actual damages, may recover [punitive] damages." Cal. Civ. Code § 3294.¹

The first finding of fraud, by itself, does not fulfill the requirement that the issues must be identical for collateral estoppel to take effect. There are two types of fraud under California law. To establish actual fraud or deceit, a plaintiff must prove (1) that material misrepresentations were made by the defendant; (2) that the defendant knew them to be untrue or did not have sufficient knowledge to warrant a belief that they were true; (3) that the defendant made the misrepresentations with intent to defraud the plaintiff; (4) that the plaintiff justifiably relied on the misrepresentations; and (5) that the plaintiff suffered damages as a result. See, e.g., Cal. Civ. Code §§ 1572, 1709-10; Molko v. Holy Spirit Assoc. for the Unity of World Christianity, 46 Cal. 3d 1092, 1129 (1988); Hobart v. Hobart Estate Co., 26 Cal. 2d 412, 422 (1945). To establish constructive fraud under California law, a plaintiff needs to demonstrate (1) that a

¹ Although the Superior Court reached the second finding of fraud by a clear and convincing standard, the difference is irrelevant to the legal analysis because this burden of proof is a higher standard of proof than that of a preponderance of the evidence, and this nondischargeability proceeding is governed by a preponderance of the evidence standard. See generally Grogan, 498 U.S. at 280-87.

1 fiduciary relationship existed (2) in which the defendant breached
2 his fiduciary duty (3) by misleading the plaintiff to his prejudice
3 (4) without an actually fraudulent intent, and (5) thus gained an
4 advantage to himself. Cal. Civ. Code § 1573; see also Odorizzi v.
5 Bloomfield School Dist., 246 Cal. App. 2d 123, 129 (1966).

6 The elements of fraud under state law must then be compared
7 to the elements of fraud for the dischargeability provisions of the
8 Bankruptcy Code. In order to except the debt from discharge under
9 523(a)(2)(A), the creditor must prove (1) that the debtor made the
10 misrepresentations; (2) that at the time he made them he knew they
11 were false; (3) that he made them with the intention of deceiving
12 the creditor; (4) that the creditor justifiably relied on these
13 misrepresentations; and (5) that the creditor suffered damages as
14 a result. See Britton v. Price (In re Britton), 950 F.2d 602, 604
15 (9th Cir. 1991).

16 To except the debt from discharge under 523(a)(4), the
17 creditor needs to demonstrate (1) that a fiduciary relationship
18 existed between the plaintiff and the defendant; (2) that the
19 requisite trust relationship existed prior to and without reference
20 to the act of wrongdoing; and (3) that the defendant committed
21 fraud or defalcation while acting in such capacity. See Otto v.
22 Niles (In re Niles), 106 F.3d 1456, 1459 (9th Cir. 1997). The
23 definition of fraud for 523(a)(4) is "the same as that stated for
24 523(a)(2)(A)." McDaniel v. Border (In re McDaniel), 181 B.R. 883,
25 887 (Bankr. S.D. Tex. 1994).²

26 _____
27 ² Defalcation is the innocent, intentional, or negligent
28 "misappropriation of trust funds or money held in any fiduciary
capacity; the failure to properly account for such funds." Lewis

1 Although the meaning of "fiduciary capacity" under 523(a)(4)
2 is narrowly defined under federal law, "courts look to state law
3 to determine whether the requisite trust relationship exists."
4 Woodworking Enter. v. Baird (In re Baird), 114 B.R. 198, 202
5 (B.A.P. 9th Cir. 1990). See also Ragsdale v. Haller, 780 F.2d 794,
6 796 (9th Cir. 1986). "If state law creates an express or technical
7 trust relationship between the debtor and another party and imposes
8 trustee status upon the debtor, the debtor will be a fiduciary
9 within section 523(a)(4)." Schieber v. Hooper (In re Hooper), 112
10 B.R. 1009, 1013 (B.A.P. 9th Cir. 1990). It is well settled in
11 California law that a real estate agent is a fiduciary who has the
12 same obligation of undivided service and loyalty that the law
13 imposes on a trustee in favor of his beneficiary. See, e.g.,
14 Batson, 68 Cal. 2d at 674-75; Ziswasser v. Cole & Cowan, Inc., 164
15 Cal. App. 3d 417, 421 (1985); Ford v. Cournale, 36 Cal. App. 3d
16 172, 180 (1973).

17 The determinative issue is whether the defendant was acting
18 within the scope of his licensed activities in the relationship.
19 See Woosley v. Edwards (In re Woosley), 117 B.R. 524, 529-30
20 (B.A.P. 9th Cir. 1990). The purchase and leasing of real property,
21 activities which the state court found Reece to have performed on
22 the Laras' behalf, both clearly fall within the scope of the acts
23 of a real estate broker as defined by California law. See Cal.
24 Bus. & Prof. Code § 10131. The Superior Court's ruling that Reece
25 was acting within the scope of his licensed activities when he
26 _____
27 v. Scott (In re Lewis), 97 F.3d 1182, 1186 (9th Cir. 1996). Since
28 the state court made specific findings of fraud, however,
defalcation is not applicable to this discussion.

1 defrauded the Laras, supplemented by the abundant California case
2 and statutory laws that establish a fiduciary duty between real
3 estate agents and their principals, serve to fulfill the
4 "fiduciary capacity" requirement of 523(a)(4).

5 The state court's first finding of fraud is not identical to
6 the fraud necessary for a debt to be ruled nondischargeable under
7 523(a)(2)(A) and (a)(4). First, since the state court found that
8 a fiduciary relationship existed, and since it did not distinguish
9 its first finding of fraud as either actual or constructive fraud,
10 this court cannot make a determination whether the first finding
11 of fraud represents actual or constructive fraud. Second, the
12 elements of actual and constructive fraud in California law do not
13 match up exactly with the elements for actual and fiduciary fraud
14 in bankruptcy law. The actual fraud of 523(a)(2)(A) requires that
15 the debtor had knowledge that the misrepresentations were false.
16 See In re Britton, 950 F.2d at 604. The fiduciary fraud of
17 523(a)(4), having the same definition as actual fraud, would
18 likewise require a knowledge component. In California,
19 nevertheless, actual fraud can be proven if the defendant "knew the
20 misrepresentations to be untrue or *did not have sufficient*
21 *knowledge to warrant a belief that they were true* [emphasis
22 added]." Hobart, 26 Cal. 2d at 422. Constructive fraud, moreover,
23 can be proven even *in the absence of fraudulent intent*. Cal. Civ.
24 Code § 1573. It is clear from this analysis that without further
25 illumination from the Superior Court's default judgment, an issue
26 of whether Reece had knowledge of the falsity of his
27 misrepresentations would remain.

1 The state court's additional finding that Reece "carried out
2 the acts alleged in plaintiffs' first amended complaint with
3 oppression, fraud, and malice," coupled with its first finding
4 regarding the existence of fraud, misrepresentation, deceit, and
5 a fiduciary relationship, does, however, finally resolve this
6 question in the Laras' favor. The fraud in this second finding is
7 the fraud that will give rise to punitive damages, and it has a
8 slightly different meaning than the fraud that will give rise to
9 liability. Fraud in this case is defined as "an intentional
10 misrepresentation, deceit, or concealment of a material fact *known*
11 *to the defendant* with the intention on the part of the defendant
12 of thereby depriving a person of property or legal rights or
13 otherwise causing injury [emphasis added]." Cal. Civ. Code § 3294.
14 The Laras' first amended complaint, furthermore, alleged that Reece
15 made the misrepresentations with knowledge of their falsity. The
16 state court determined the allegations contained in the complaint
17 to be true. An examination of the state court's first findings
18 in light of its second findings, therefore, produces the clear
19 conclusion that the Superior Court must have found Reece guilty of
20 perpetrating fraud with knowledge. Satisfaction of the knowledge
21 component, in turn, indicates that the fraud previously proven in
22 the state court is on all fours with the fraud that presently needs
23 to be proven in this bankruptcy court for nondischargeability
24 purposes. Thus, the issues that were litigated are identical to
25 the issues to be precluded. The state court's decision, therefore,
26 meets all the elements of issue preclusion, and the doctrine of
27 collateral estoppel functions to prevent Reece from denying that
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1 he did not commit actual fraud or fraud in a fiduciary capacity in
2 his dealings with the Laras.

3 **2. The Default Judgment's Collateral Estoppel**
4 **Effect on § 523(a)(6).**

5 The state court's findings of malice, however, cannot overcome
6 all the hurdles needed for collateral estoppel to operate in the
7 context of the § 523(a)(6) claim. To establish malice for the
8 purposes of assessing punitive damages in California, the plaintiff
9 must show that the defendant engaged in conduct "which is intended
10 by the defendant to cause injury to the plaintiff or despicable
11 conduct which is carried on by the defendant with a willful and
12 conscious disregard of the rights or safety of others." Cal. Civ.
13 Code § 3294. To render a debt nondischargeable under the "willful
14 and malicious injury" exception of 523(a)(6), the creditor must
15 show that the debtor committed the harmful acts with the specific
16 intent to injure the creditor. See Kawaahau v. Geiger, ___U.S.____,
17 118 S. Ct. 974, 977 (1998). After undertaking a rigorous scrutiny
18 of the state court decision, the court remains uncertain as to
19 whether the debtor acted with intent to cause injury or merely with
20 conscious disregard of the creditor's rights. While the former
21 would except the debt from discharge under 523(a)(6), the latter
22 would not. Either degree of mental culpability, nevertheless,
23 could have been the basis for the state court's finding of malice
24 in awarding punitive damages.

25 Although the state court made an additional finding of
26 "oppression" along with "malice" in its decision to award punitive
27 damages, nonetheless, "'oppression' as defined and interpreted by
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1 California courts is equivalent to 'malice'." Aubrey v. Thomas (In
2 re Aubrey), 111 B.R. 268, 275 (B.A.P. 9th Cir. 1990). Despite the
3 equivalent treatment of the terms by bankruptcy courts in
4 California, they still possess slightly different legal
5 definitions. "Oppression" under California law "means despicable
6 conduct that subjects a person to cruel and unjust hardship in
7 conscious disregard of that person's rights." Cal. Civ. Code §
8 3294. The scienter element of the "willful and malicious injury"
9 exception requires a specific intent to injure rather than simply
10 conscious disregard, recklessness, or negligence. Kawaahau, 118
11 S. Ct. at 977. Furthermore, if the court were to equate
12 "oppression" with "malice," the aforementioned question would
13 remain as to the basis of the state court's "malice" finding. The
14 Superior Court's finding of "oppression" thus does not help the
15 Laras' request to have the court declare the debt nondischargeable
16 under 523(a)(6).

17 The Laras contend that punitive damage awards based on
18 findings of oppression and malice under Cal. Civ. Code § 3294 can
19 only properly be made in response to wrongful acts that would, by
20 definition, also violate 11 U.S.C. § 523(a)(6). See, e.g.,
21 Krishnamurthy v. Nimmagadda (In re Krishnamurthy), 209 B.R. 714,
22 721 (B.A.P. 9th Cir. 1997); Giangrasso v. Butler (In re
23 Giangrasso), 145 B.R. 319, 323 (B.A.P. 9th Cir. 1992); In re Moore,
24 186 B.R. at 973. However, the bankruptcy courts were, at the time
25 when these cases were decided, laboring under the interpretation
26 of § 523(a)(6) given by the Ninth Circuit in Impulsora del
27 Territorio Sur v. Cecchini (In re Cecchini), 780 F.2d 1440 (9th
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1 Cir. 1986). The Ninth Circuit's construction of the "willful and
2 malicious injury" exception has since been overruled by the United
3 States Supreme Court. Compare In re Cecchini, 780 F.2d at 1442,
4 with Kawaahau, 118 S. Ct. at 977. See also AVCO Fin. Serv. v. Kidd
5 (In re Kidd), 219 B.R. 278, 283-84 (Bankr. D. Mont. 1998).

6 An argument can be made that Reece's perpetration of fraud
7 with knowledge represents the "willful and malicious injury" of the
8 exception. However, "we are hesitant to adopt an interpretation
9 of a congressional enactment which renders superfluous another
10 portion of the same law." Mackey v. Lanier Collection Agency &
11 Serv. Inc., 486 U.S. 825, 837 (1988). Determining fraud to be a
12 "willful and malicious injury" for 523(a)(6) would make unnecessary
13 the 523 (a)(2)(A) and (a)(4) exceptions regarding actual fraud and
14 fiduciary fraud, respectively. In sum, given the uncertain basis
15 of the state court's "malice" finding, and without further evidence
16 introduced by the parties, the default judgment cannot meet all
17 requirements of collateral estoppel necessary for its operation in
18 the context of a § 523(a)(6) claim.

19 **B. The Availability of Affirmative Defenses**

20 Satisfaction of the requirements of collateral estoppel,
21 however, does not terminate the legal analysis. California case
22 law places default judgment in a category separate from trial
23 judgments with respect to the extent of its preclusive effect.
24 "Although a default judgment is conclusive as to facts necessary
25 to uphold that particular judgment, it is not conclusive in a
26 subsequent suit on a different cause of action against any defenses
27 which defendant has, because the issues raised by these defenses
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1 were not tried and cannot be deemed adjudicated. This [is] an
2 exception to the normal rules of res judicata, limited to default
3 judgments." Sutphin v. Speik, 15 Cal. 2d 195, 203 (1940)
4 (explaining the holding of English v. English, 9 Cal. 2d 358, 363-
5 64 (1937)). "Where a given issue or defense is not raised in the
6 prior proceeding, a default judgment does not operate as a
7 conclusive adjudication so as to collaterally estop the defendant
8 from raising the issue or defense in a subsequent proceeding . .
9 . The general principle that a defendant waives defenses not raised
10 or asserted is inapplicable in the context of a default judgment."
11 In re Moore, 186 B.R. at 975 (citing Mitchell v. Jones, 172 Cal.
12 App. 2d 580, 586-87 (1959)). Therefore, although Reece is estopped
13 from denying the allegations of fraud, he may still raise
14 affirmative defenses in this bankruptcy proceeding against the
15 Laras' charges. According to Rule 8(c) of the Federal Rules of
16 Civil Procedure, a defendant must set forth the various affirmative
17 defenses that he plans to raise in his answer to the plaintiff's
18 complaint. Fed. R. Civ. P. 8(c). This procedural rule has been
19 made applicable to adversary proceedings in the bankruptcy courts.
20 Fed. R. Bankr. P. 7008. In this proceeding, Reece proposed no
21 less than twenty-two affirmative defenses in his answer to the
22 Laras' amended complaint, among them failure to state a claim,
23 contributory negligence, laches, failure to mitigate damages,
24 release, barring of claim by the statute of limitations, lack of
25 consideration in contract, and failure to plead facts with
26 particularity. In light of the preclusive effect on the issue of
27 fraud established by the default judgment, and given the facts pled
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1 by both parties, however, none of the affirmative defenses
2 introduced by Reece has any factual or legal merit. Therefore,
3 although Reece has the opportunity to present affirmative defenses
4 to counter the collateral estoppel effect of a default judgment,
5 and although he raised many of them timely in his answer, upon
6 careful evaluation, the affirmative defenses raised present no
7 genuine issue as to Reece's liability for knowingly defrauding the
8 Laras and their legal right to recover damages from him.

9 **C. The Extrinsic Fraud Exception**

10 A state court judgment may be subject to collateral attack if
11 the judgment was procured through extrinsic fraud. Gonzalez v.
12 Parks, 830 F.2d 1033, 1036 (9th Cir. 1987). Extrinsic fraud is an
13 exception to the Full Faith and Credit clause of 28 U.S.C. § 1738
14 and, when proven, will enable federal courts, including bankruptcy
15 courts, to disregard the collateral estoppel effect of a state
16 court judgment. In re Lake, 202 B.R. at 758. Determinations of
17 whether extrinsic fraud exists will be made under state law. Id.
18 To establish a case for vacating a California state court default
19 judgment based on extrinsic fraud, the movant must (1) plead and
20 prove that he has a meritorious case, New York Higher Educ.
21 Assistance v. Siegel, 91 Cal. App. 3d 684, 689 (1979), (2) provide
22 a satisfactory excuse for not defending against the original
23 action, Stiles v. Wallis, 147 Cal. App. 3d 1143, 1146 (1983), and
24 (3) show diligence in setting aside the default once it was
25 discovered. Id. The movant must make a substantially higher
26 showing for all these requirements than is necessary to obtain
27 relief under statute. See In re Marriage of Stevenot, 154 Cal.

1 App. 3d 1051, 1074 (1984).

2 After Reece made the allegation in his declaration that the
3 judgment was unfairly obtained because he was neither given notice
4 of the request for the entry of default nor notified of the
5 evidentiary hearing which resulted in the entry of the judgment,
6 this court ordered both parties to submit briefs on that issue as
7 well as the issue of collateral estoppel. Reece has thus been
8 given ample time and opportunity to present evidence of extrinsic
9 fraud to the court. However, in his submissions to the court, he
10 has not met his burden of pleading and proving a meritorious case
11 for extrinsic fraud. Neither has he provided a satisfactory excuse
12 for not defending against the original action. In fact, Reece has
13 not even discussed the factors necessary for vacating a California
14 state court's default judgment based upon extrinsic fraud.
15 Therefore, the court cannot ignore the Superior Court's judgment
16 and will instead grant it the preclusive effect it deserves under
17 28 U.S.C. § 1738.

18 **D. The (Non)Dischargeability of Damages**

19 The preclusive effect of the state court default judgment
20 prevents Reece from denying the commission of actual and fiduciary
21 fraud. The affirmative defenses raised by Reece lack legal and
22 factual merit. Since the Laras have established Reece's liability
23 for actual and fiduciary fraud in spite of the affirmative defenses
24 he asserted, there exists no genuine issue as to Reece's liability
25 under 523(a)(2)(A) and 523(a)(4). According to these exceptions
26 to discharge, any debt resulting from actual and fiduciary fraud
27 must be ruled nondischargeable. 11 U.S.C. §§ 523(a)(2)(A) and
28

1 523(a)(4).

2 The state court granted to the Laras general and special
3 compensatory damages, punitive damages, prejudgment interest, and
4 attorney fees totaling over \$1.2 million. The nondischargeability
5 of punitive damages, prejudgment interest, and attorney fees
6 arising from the fiduciary fraud of 523(a)(4) has been well-
7 established in bankruptcy law. See Bugna v. McArthur (In re
8 Bugna), 33 F.3d 1054, 1058 (9th Cir. 1994) (punitive damages
9 nondischargeable under 523(a)(4)). See also Stokes v. Vierra, 185
10 B.R. 341, 345 n.5 (N.D. Cal. 1995) (attorney fees and prejudgment
11 interest nondischargeable under 523(a)(4)). The United States
12 Supreme Court recently addressed the issue of whether punitive
13 damages and attorney fees are also nondischargeable under
14 523(a)(2)(A) in Cohen v. Cruz, ___U.S.___, 118 S. Ct. 1212 (1998).
15 In the unanimous opinion, the Court ruled that for the purposes of
16 523(a)(2)(A), "'any debt . . . for money, property, services, or
17 . . . credit, to the extent obtained by' fraud encompasses any
18 liability arising from money, property, etc., that is fraudulently
19 obtained, including treble damages, attorney's fees, and other
20 relief that may exceed the value obtained by the debtor." Id. at
21 1218. This holding overruled the existing law of the Ninth Circuit
22 regarding the dischargeability of punitive damages under
23 523(a)(2)(A). Compare Palmer v. Levy (In re Levy), 951 F.2d 196,
24 197-98 (9th Cir. 1991), with Cohen, 118 S. Ct. at 1218. Therefore,
25 the punitive damages, prejudgment interest, and the attorney fees
26 that Reece owes to the Laras are nondischargeable.

27 The state court made findings of both fraud and negligence in
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1 its brief decision. Beyond making those findings, the Superior
2 Court unfortunately did not explain which portion of the
3 compensatory damages resulted from fraud and which portion resulted
4 from negligence. Sections 523(a)(2)(A) and 523(a)(4) are only
5 applicable to that part of the debt which has been fraudulently
6 obtained, and any damages resulting from negligently inflicted
7 injuries are no longer excepted from discharge under 523(a)(6).
8 See Kawaahau, 118 S. Ct. at 978. Once again, without further
9 clarification of the state court's judgment, the court cannot make
10 a determination as to whether the entire amount of general and
11 special compensatory damages was awarded due to Reece's liability
12 for fraud or whether any part of that award went to compensate the
13 Laras for his negligence. An evidentiary hearing will be needed
14 in which the Laras must show that portion of the compensatory
15 damage award which flowed from Reece's acts of actual and fiduciary
16 fraud.

17 **V. CONCLUSION**

18 For the foregoing reasons, the Laras' motion for summary
19 judgment is partially granted as to Reece's liability for actual
20 and fiduciary fraud under 523(a)(2)(A) and 523(a)(4), respectively.
21 The Laras' motion for summary judgment is denied as to Reece's
22 liability for willful and malicious injury under 523(a)(6). The
23 Laras' motion for summary judgment is also denied as to the total
24 amount of damages owed by Reece. Since the motion for summary
25 judgment is granted only as to Reece's liability, an evidentiary
26 hearing will be necessary for the Laras to show the exact amount
27 of the nondischargeable debt arising from Reece's perpetration of
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1 actual and fiduciary fraud.

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